

# Reform of the Australian Federation

Submission to the Senate Select Committee August 2010



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representation



Invigorating Business Representation

## Executive Summary

The NSW Business Chamber welcomes the opportunity to make a submission regarding reform of the Australian Federation. The NSW Business Chamber represents the interests of around 30,000 companies across NSW and the ACT, ranging from owner-operators to corporations and from manufacturers to service providers.

The current relationship between Federal, State<sup>1</sup> and Local Governments in Australia is not the end result of a carefully planned and well thought out process. Rather, it reflects the gradual evolution of a legal framework that was first put in place over a hundred years ago, at a time when the relative roles, powers and responsibilities of the various levels of government was very different. While this evolution is probably a fair reflection of the wishes of the Australian people, the legal changes to facilitate this have been driven by an ad hoc series of court decisions rather than taking a strategic and collaborative approach to reform of the Federation.

This incremental evolution has resulted in several undesirable outcomes.

There are now significant overlapping roles and responsibilities in a range of areas of Government activity. These overlapping and ambiguous policy areas have led to fragmented regulation and services, a lack of coordination, duplication of effort, and buck passing between levels of Government.

Significant financial imbalances are also present in the current arrangements. The Federal Government now collects far more revenue than required to meet its needs, and the States are now reliant on transfers from the Federal Government to meet their expenditure needs. This has both reduced the autonomy and capacity of States to raise revenue, and has also resulted in complications for the Federal Government in determining the appropriate way to distribute financial support among the States.

The Henry Review has proposed a number of longer-term reforms in this area, but to date Federal and State Governments have shown little interest in discussing the merits of these recommendations.

Local Governments also face a range of similar challenges. Raising sufficient revenue to meet expenditure needs is an ongoing concern for local government, and in the case of NSW, rate pegging has compounded this challenge.

Looking at the governance of Local Governments more broadly, demographic changes over the decades have meant that many local council boundaries are no longer appropriate. Some areas, in particular Sydney, are over governed at this level. Amalgamation of a number of local councils in the Sydney area could allow for more strategic decision making.

For the business community, it is very important that the operation of the Federation is as efficient and effective as possible. Dysfunctional aspects of our Federation are an impediment to businesses and undermine sustainable productivity growth.

The resources boom has masked a slowing in Australia's productivity growth in recent years. However, this boom cannot be expected to last forever, and Governments at all levels need to look to encourage productivity growth to ensure that the Australian economy remains competitive into the future.

While many of the concerns about the Australian Federal system have been identified by previous reports and by other organisations, the challenge for all levels of government is to implement reform. The current framework often means that the Government with the power to implement a reform has little incentive to do so. For example, many State taxes are commonly acknowledged as being highly inefficient, but there is little incentive for State Governments to seek to reform these taxes. At a broader level, substantial changes in many areas requires the agreement of all Federal and State Governments. Making progress in reforming the Australian Federation will require greater cooperation between all levels of Government, and an ability for decision makers to act in the country's best interests rather than their own self-interest.

### **Recommendation 1:**

**State and Federal Governments should increase their focus on resolving areas of overlapping responsibility. This could be managed through a refocussed Premiers' and Prime Minister's forum running in parallel to COAG.**

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<sup>1</sup> In this submissions, references to the "State" and "States" are taken to include both State and Territory Governments.

**Recommendation 2:**

The Federal and State Governments should better match tax assignment with expenditure responsibilities, by ending multiple government funding of education.

**Recommendation 3:**

The Productivity Commission should review the appropriateness of the current process of Horizontal Fiscal Equalization, and compare the Australian system with those currently in place in other federations around the world.

**Recommendation 4:**

The Productivity Commission should investigate whether it would be more efficient for a single body to administer all State and Federal taxes.

**Recommendation 5:**

The Federal Government should drive the COAG process towards a medium-term strategic plan for the implementation of the State tax reforms outlined in the Henry Review.

**Recommendation 6:**

The Federal Government should continue to use COAG to expand and accelerate interstate tax and regulation harmonisation.

**Recommendation 7:**

The Productivity Commission should investigate whether local government amalgamations in capital cities could improve the efficiency and effectiveness of this level of government.

**Recommendation 8:**

The IPART recommendations regarding rate pegging should be adopted in NSW, with future revenue increases tied to performance improvement.

## The rationale for reform

The current system of Federation has created a number of challenges which impede efficient Government, such as the current vertical fiscal imbalance between the States and the Federal Government, and the confused and blurred lines of accountability and responsibility between levels of Government.

For the business community, it is very important that the operation of the Federation is as efficient and effective as possible. Dysfunctional aspects of our Federation act as an impediment to businesses and undermine sustainable productivity growth.

For example, Professor Ross Garnaut recently noted that blurring of State and Federal responsibility for delivery of infrastructure has led to dysfunctional outcomes with detrimental consequences for the nation's productivity:

*"It has been recognised for at least the past decade that weaknesses in the provision of transport and other infrastructure are major drags on Australian economic performance. These matters are constitutionally within the responsibility of the States, but have been rendered joint responsibilities by developments within Federal-State financial relations. Actions to correct weaknesses have been small and piecemeal, without comprehensive, transparent, independent analysis of the range of alternatives. Effective action is held back because no level of Government is unambiguously in charge of the massive sustained effort that is required. Those steps that have been taken have been highly politicised and correspondingly ineffective. The capacity of transport infrastructure has grown less rapidly than the demand for it."*<sup>2</sup>

Productivity growth is both good for businesses and for the economic prosperity of the nation overall. In its latest Intergenerational Report, Treasury stated that "productivity growth will be the major contributor to real GDP per person growth in Australia over the next 40 years."<sup>3</sup> The Report identifies enhancing productivity as the key to increasing economic growth, improving living standards and offsetting the fiscal pressures of ageing.<sup>4</sup>

Australia's productivity growth has slowed in recent years, averaging 1.4 per cent over the past decade, substantially lower than the 2.1 per cent annual growth realised during the 1990s.<sup>5</sup> Treasury calculates that if productivity growth could be maintained at 2 per cent per annum over the next 40 years, the economy would be 15 per cent larger than if productivity growth averaged 1.6 per cent.<sup>6</sup>

The poor productivity growth experienced in Australia more recently has been masked by the resources boom. While this boom continues to support Australia's prosperity in the near-term, it cannot last indefinitely and is not a long-term substitute for productivity improving reforms.

There are many fields where Governments can implement productivity enhancing reforms, and reform of the Australian system of Federation is certainly one such area.

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<sup>2</sup> Ross Garnaut, *speech – Climate Change, China Booms and Australia's Governance Struggle in a Changing World*, 5 August 2010

<sup>3</sup> Australian Treasury, *Australia to 2050: future challenges*, January 2010 IGR, p. xii.

<sup>4</sup> *ibid.*, p. vii.

<sup>5</sup> *ibid.*, p. xii.

<sup>6</sup> *ibid.*



## Who is responsible?

“Federations work best when the roles and responsibilities of each jurisdiction are clear and good public accountability mechanisms allow the community to hold the appropriate level of government to account for the quality and efficiency of the services delivered and outcomes achieved.”<sup>7</sup>

This is the benchmark that the Australian Federation should strive to achieve. Unfortunately, current arrangements fall well short of this ideal. As noted by Federal Treasury in the 2010-11 Budget, “Australia’s federal relations are characterised by ... overlapping roles and responsibilities in areas of government activity which can lead to sectors where regulation or services remain fragmented, with duplication of activities, lack of coordination and blurred accountabilities.”<sup>8</sup>

The current relationship between State and Federal Governments in Australia is not the end result of a carefully planned and well thought out process. Rather, it reflects the gradual evolution of a legal framework that was first put in place over a hundred years ago, at a time when the relative roles, powers and responsibilities of the State and Federal Governments was very different.

When the Australian Constitution was passed into law in 1901, the Federal Government had a relatively small set of powers and the bulk of responsibilities lay with the States. Each State operated fairly independently and each had a great deal of autonomy in controlling the operation of its own jurisdiction.

Over time, Australia has become much more closely integrated. The Federal Government has gradually broadened its role in legislating on issues and collecting tax revenues, and in both cases this has narrowed the autonomy of the States. While this evolution is probably a fair reflection of the wishes of the Australian people, the legal changes to facilitate this have been driven by an ad hoc series of court decisions rather than taking a strategic and collaborative approach to reform of the Federation.

This incremental approach has resulted in several undesirable outcomes. One of these is that the Federal Government now collects far more revenue than it needs to meet its needs, and that the States are now reliant on transfers from the Federal Government to meet their expenditure needs. This issue is examined further in the next section on financing.

The gradual evolution of the Federal framework has also meant that there are now significant overlapping roles and responsibilities in a range of areas of Government activity. These overlapping and ambiguous policy areas have led to fragmented regulation and services, a lack of coordination, duplication of effort, and buck passing between levels of Government.

These issues are not limited to a narrow range of policy fields, and are apparent in areas such as education, economic affairs, housing and community amenities, and recreation and culture. The result is that the Australian Federation suffers from a ‘confused mix of responsibilities’ along with a lack of transparency and diminished accountability.<sup>9</sup>

Professor Garnaut recently noted that:

*“... the continuing tendency of tied grants from the Commonwealth to turn State into joint powers removed exclusive State and Territory responsibility for all of the main State functions. The blurring of responsibility was a major barrier to improved performance in all of the areas that have turned out to be crucial to the outstanding agenda of productivity-raising reform—transport infrastructure, resources taxation, education and health. In these areas, no-one within the Australian Federal system is unambiguously in charge—and no-one will ever be unambiguously in charge without fundamental reform of Federal fiscal arrangements.”<sup>10</sup>*

<sup>7</sup> Commonwealth Treasury, *2010-11 Budget*, Budget Paper No. 3, p. 7.

<sup>8</sup> *ibid.* p. 4.

<sup>9</sup> Neil Warren, *Benchmarking Australia’s Intergovernmental Fiscal Arrangements: Final Report*, 2006, p.124

<sup>10</sup> Ross Garnaut, *speech – Climate Change, China Booms and Australia’s Governance Struggle in a Changing World*, 5 August 2010

As Treasury acknowledges, when the community can hold either level of government accountable, a State can blame any shortfall in service on inadequate funding from the Federal Government, while the Federal Government can blame poor outcomes on either the administrative or financial incompetence of the State.<sup>11</sup>

It is concerning that the operation of the Federation appears to be becoming increasingly dysfunctional. Increasingly, major debates in areas such as taxation, infrastructure, health, workplace relations and education have become demarcation disputes between the Federal and State Governments.

One of the reasons behind this dysfunction is that traditionally governments compartmentalize and departmentalize, viewing problems and solutions in structural and procedural ways.

The Australian population and business community see the world differently. They don't care if an issue is Federal, State or Local; they just want someone to fix the problems they face. They don't want to be palmed off to someone else; they want governments driven by delivering services, not process.

The concern of business is that the dysfunction of the Federation has become a drain on Australia's capacity to achieve and grow. The Business Council of Australia conservatively estimates the cost of this dysfunction to be \$9 billion.<sup>12</sup>

While the efforts have recently been made through the COAG process to address some of these overlapping areas of responsibility in relation to health, there are many other policy fields where better delineation of responsibilities is required. It is disappointing that neither of the major political parties have put this issue high on their agenda for the next term of Federal Government.

It is unclear whether the COAG process has the political will and momentum necessary to continue making inroads into clarifying responsibilities between State and Federal Governments. A streamlined version of COAG, with membership limited to Premiers and the Prime Minister, may be more successful in progressing such an agenda. Whatever process is chosen, it is essential that it be singly focussed on improving Australia's productivity through reform of the Federal and State systems of Government.

**Recommendation 1:**  
**State and Federal Governments should increase their focus on resolving areas of overlapping responsibility. This could be managed through a refocussed Premiers' and Prime Minister's forum running in parallel to COAG.**

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<sup>11</sup> Commonwealth Treasury, *Architecture of Australia's tax and transfer system*, August 2008, p.303

<sup>12</sup> Business Council of Australia, *Reshaping Australia's Federation – a New Contract for Federal-State Relations*, p. 7.

## Financing

The NSW Business Chamber believes that Australia’s system of intergovernmental financial arrangements is unduly complex and inefficient. This is hindering the ability of Australian governments to meet critical structural challenges associated with the ageing of the population, heightened international competition, and the provision of infrastructure.

Unless Australia’s intergovernmental financial arrangements are reformed, Australian-based businesses will continue to be stifled by unnecessary tax and regulatory burdens, inadequate infrastructure support, and additional investment uncertainty.

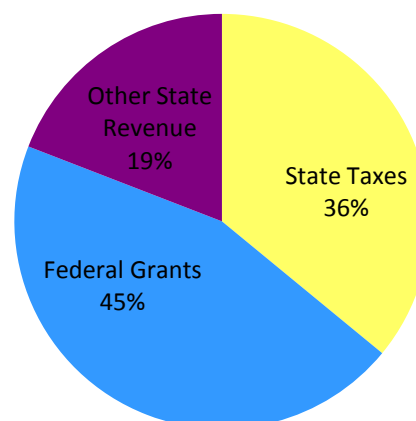
### Vertical Fiscal Imbalance

Significant vertical fiscal imbalance exists between the States and the Federal Government. The States have significant expenditure responsibilities relative to their capacity to raise this revenue, while the Federal Government has a relatively narrow range of responsibilities supported by a much deeper tax pool. This situation means that the States are reliant on transfers from the Federal Government to finance a significant proportion of their activities.

Australia’s existing intergovernmental financial arrangements present major obstacles to the long-term fiscal viability of the States. Addressing the vertical fiscal imbalance that exists between the State and Federal Governments will put State finances on a more sound footing. Better alignment between States’ revenue raising capacities and expenditure responsibilities will also enable the States to improve their delivery of essential Government services.

The vertical fiscal imbalance between Australian governments arises because the Federal Government enjoys the most robust and broad-based taxes, whereas the States depend on taxes that have narrow bases and whose revenues are highly sensitive to changes in the business cycle. This accounts for why, in 2008-09, the Federal Government collected 82 per cent of total tax revenue in Australia,<sup>13</sup> while Federal Government grants made up 45 per cent of total NSW State revenue in the same year.<sup>14</sup>

**Chart 1: Sources of NSW Government funding, 2008-09<sup>15</sup>**



Restrictions on the taxing powers of State and Territory Governments mean that States are unable to take unilateral action to address this issue. These restrictions on State powers mean that State Governments are forced to rely on

<sup>13</sup> Australian Bureau of Statistics, *5506.0 Taxation Revenue – Australia*, April 2010

<sup>14</sup> NSW Treasury, *2010-11 Budget*, Budget Paper No. 2, Chap 5, p. 8.

<sup>15</sup> *ibid.*

the few taxing powers they have for significant amounts of revenue, even where it is commonly acknowledged that such taxes are inefficient and volatile. This can hamper the process of State tax reform.

For example, payroll taxes have long been argued by industry as a tax on jobs. More recently, the Henry Review also noted that State payroll taxes are inefficient and reduce labour productivity, and recommended their abolition.<sup>16</sup> It could be argued that replacing the existing payroll tax framework with a broad based tax on consumption or incomes would improve the overall efficiency of the tax system. However, States do not have the power to levy these types of taxes.<sup>17</sup>

The existing vertical fiscal imbalances are compounded by the fact that demographic changes will place increasing pressure on overall Government expenditure over the medium-term. Between 2006-07 and 2010-11, expenditure growth in NSW has been highest in the areas of social security and welfare (9.9 per cent per annum), health (6.8 per cent per annum), and transport and communications (5.9 per cent per annum).<sup>18</sup> These are all policy areas with overlapping State and Federal responsibilities, and are all areas where growth in expenses is running faster than the overall growth in revenues.

In NSW, the *Fiscal Responsibility Act 2005* requires the Budget to include the aggregate long-run fiscal consequences of the Government's policy decisions. This analysis suggests that the Government's capacity to meet the challenges of demographic changes of the next 30 to 40 years is deteriorating rather than improving. In the 2006-07 Budget, the NSW Government estimated that projecting the 2004-05 Budget outcome forward to 2043-44 would lead to a fiscal gap of around 3.4 per cent of GSP. Policy changes between 2006-07 and 2009-10 widened the fiscal gap to 4.3 per cent, and the 2010-11 Budget further widened the fiscal gap to 4.9 per cent.<sup>19</sup>

NSW Treasury has noted that:

"...a slowdown in the growth in the working age population, and consequently employment and gross state product (GSP) growth, can be expected to slow the growth of revenues. The combined effects of these anticipated trends in expenses and revenues will place the budget under pressure. It also brings into sharp focus the current and prospective expenditure and revenue responsibilities of the Federal Government and the States. Current structural arrangements are unsustainable in the long run."<sup>20</sup>

This is supported by the findings of the Henry review, which noted that: "Increasing the rates of tax on existing State taxes would not be a sustainable way of funding services in the future."<sup>21</sup>

The issue of vertical fiscal imbalance can be addressed by transferring responsibilities to the Federal Government, or by giving State Governments greater fiscal autonomy. In a recent review of State taxation, IPART identified several options for improving State efficiency and fiscal autonomy, including the reassignment of one or more efficient Federal taxes to the States. However, IPART also acknowledged that this option carried the risk that "political and competitive pressures may result in changes to tax that reduce their efficiency."<sup>22</sup>

The alternative to shifting taxing powers to the States is to shift expenditure responsibilities to the Federal Government. Early in 2010, COAG made some efforts in this space through reform of the current health funding arrangements. This work was supported by the NSW Business Chamber, and a Federal takeover of hospital funding was one of the recommendations in the Chamber's policy blueprint – *10 Big Ideas to Grow NSW*.<sup>23</sup>

On 20 April, COAG announced that it had "reached an historic agreement on health and hospitals reform – the establishment of a National Health and Hospitals Network."<sup>24</sup> With the exception of Western Australia, the States, Territories and Federal Government all agreed to the Federal Government retaining one third of GST revenues, and in return becoming the dominant funder of the nation's hospital system. While this transfer is broadly revenue neutral in the early years of the agreement, over time this change will reduce vertical fiscal imbalance as growth in States' health expenditure would have grown more rapidly than their increase in GST revenue.

<sup>16</sup> *Australia's Future Tax System – Final Report*, December 2009, p. 301.

<sup>17</sup> For example, in 1989 the Commonwealth Government legislated to ban States from introducing an income tax surcharge.

<sup>18</sup> NSW Treasury, *2010-11 Budget*, Budget Paper No. 2, Chap 4, Table 4.3, p. 22.

<sup>19</sup> NSW Treasury, *2010-11 Budget*, Budget Paper No. 2, Chap 3, pp. 19-20.

<sup>20</sup> NSW Treasury, *2008-09 Budget*, Budget Paper No. 2, Chap 2, p. 4.

<sup>21</sup> *Australia's Future Tax System – Final Report*, December 2009, p. 669.

<sup>22</sup> IPART, *Review of State Taxation: Final Report to the Treasurer*, October 2008, p. 150.

<sup>23</sup> See [www.10bigideas.com.au](http://www.10bigideas.com.au)

<sup>24</sup> Council of Australian Governments, *COAG Communiqué – Preamble*, 20 April 2010.



While representing a significant change in the financing arrangements, it by no means comprehensively addresses the issue of vertical fiscal imbalance. Under the *National Health and Hospitals Network Agreement*, it was agreed that the Federal Government would broadly fund 60 per cent of the public hospital system, meaning that the remaining 40 per cent will continue to be funded by the States. The NSW Business Chamber continues to advocate for the Federal Government to take responsibility for a greater proportion of total health funding.

Furthermore, in areas other than health the States will continue to rely on the Federal Government for a significant proportion of their revenue, and demographic changes will continue to mean that growth in expenses exceeds growth in State revenue.

Education is another significant area of policy responsibility where funding is shared between State and Federal Government, with State Governments currently responsible for around two-fifths of education spending.<sup>25</sup> In other comparable federations, such as Canada, Germany and Switzerland, education funding is almost entirely the responsibility of a single level of government. Transferring responsibility for education services more fully to the Federal Government would assist in further alleviating the pressures from vertical fiscal imbalance.

**Recommendation 2:**

**The Federal and State Governments should better match tax assignment with expenditure responsibilities, by ending multiple government funding of education.**

## Horizontal Fiscal Equity

Each State and Territory has a different capacity to raise revenue and deliver services. For example, States with larger endowments of natural resources may find it easier to raise additional revenue, while States with a highly dispersed population may find it more expensive to deliver the same level of services as a densely populated state. Aspects of the financial arrangements between State and Federal Governments seek to address these horizontal fiscal inequities.

In allocating the GST between the States, the Commonwealth Grants Commission (CGC) applies a formula designed to achieve horizontal fiscal equity. The formula used by the CGC involves over 400 measures and is generally seen as being overly complex and convoluted. The framework applied is very technical and is only well understood by a small number of people.

The complexity of the system was well summarised by the previous Treasurer when he said, “*The State Governments spend huge resources putting their cases to the Commonwealth Grants Commission... In fact, State Treasuries probably spend more time on this than practically anything else.*”<sup>26</sup>

Professor Garnaut notes that by subjecting GST distributions to the CGC process, “What had been a minor idiosyncrasy became a central part of the Australian fiscal system, profoundly affecting incentives for sound financial management in the Federation.”<sup>27</sup>

In addition to being overly complex, the current arrangement can create perverse outcomes, and encourage States to defer reform decisions which would otherwise be in their best interest. This could act as an impediment to the implementation of a number of the State tax reforms recommended in the Henry review.

For example, under existing arrangements, those States which maintain numerous taxes with narrow bases can expect to receive a greater share of untied grants than those States which streamline their tax systems.<sup>28</sup>

Recent Intergovernmental Agreements (IGAs) have seen the introduction of National Partnership Payments (NPPs). These payments are aimed at facilitating national reform and rewarding jurisdictions that deliver them. The NSW Business Chamber supports greater use of these payments, as they effectively shift the focus from revenue distribution to service delivery outcomes. NPPs have been used by the Federal Government to promote the delivery of specific outcomes in a range of policy areas, including health, education and affordable housing. For example, under the *National Partnership on pre-apprenticeship training*, the Federal Government “will provide \$20 million to the States from 2009-10 to 2010-11 to help increase the number of pre-apprenticeship training opportunities that

<sup>25</sup> Neil Warren, *Benchmarking Australia’s Intergovernmental Fiscal Arrangements: Final Report*, NSW Government, 2006, p. 37.

<sup>26</sup> AB News, *Transcript of interview with Peter Costello*, August/September 2005

<sup>27</sup> Ross Garnaut, *speech – Climate Change, China Booms and Australia’s Governance Struggle in a Changing World*, 5 August 2010

<sup>28</sup> IPART, *Review of State Taxation: Final Report to the Treasurer*, October 2008, p. 38.

are available.<sup>29</sup> Unlike the distribution of GST monies, the payments are tied to the delivery of a particular policy outcome.

Partially quarantining NPPs from the CGC process avoids many of the problems and perverse outcomes which the HFE formula can encourage.

While NPPs represent a step in the right direction, significant flaws remain with the overall process and more needs to be done to improve the process of HFE. Australia's process of HFE continues to compare poorly with other federations. In particular, in reviewing Australia's intergovernmental fiscal arrangements, Professor Warren identified the following weaknesses:<sup>30</sup>

- Australia attempts to equalise both revenue capacities and expenditures, instead of revenues only;
- Australia's mechanism of allocation is more complex than that of other federations; and
- The Australian equalisation process relies more on variables that are endogenous (such as revenue capacity and specific expenditure costs) than those that are exogenous (such as population and gross state product).

We believe the Australian Government should ask the Productivity Commission to independently review the way in which the Commonwealth Grants Commission manages the HFE process. In particular, the Productivity Commission could investigate whether the "five pillars"<sup>31</sup> adopted by the CGC are the most appropriate framework within which to manage HFE. The Commission could make recommendations on the models that preserve the principle of HFE but incorporate it into a modern economic context. It is proposed that such a review would be limited to the appropriateness of the distribution formula, and not look at the split of responsibilities between State and Federal Government or other fiscal transfers between the levels of Government (such as NPPs).

### **Recommendation 3:**

**The Productivity Commission should review the appropriateness of the current process of Horizontal Fiscal Equalization, and compare the Australian system with those currently in place in other federations around the world.**

## Administration of taxation

Most businesses in NSW are forced to deal with at least two revenue collection agencies (the ATO and the Office of State Revenue), and for those that operate in multiple jurisdictions the number can be much higher. The ATO and OSR have different administrative arrangements, including collection dates and mechanisms for payment, which complicate arrangements and increase overall business administrative and compliance costs. Business costs could be reduced by reducing the number of agencies businesses are required to interact with and by making the interface between state and federal taxation seamless.

But it is not only businesses that stand to benefit from such reforms. Integration of the various State and Federal revenue collection bodies also has the potential to provide efficiency dividends to Governments through increased economies of scale.

The cost of collecting state taxes differs between jurisdictions. For example, in NSW the cost of collecting state taxes is 60 cents for every \$100 collected,<sup>32</sup> while in Victoria the cost is 47 cents per \$100,<sup>33</sup> a saving of more than 20 per cent. While it can be difficult to definitively say which States have the most efficient tax collection processes, it is certainly likely that some states are more efficient than others.

Over time, it could be expected that this reform would cut costs to businesses and Government, reduce red tape and improve the quality of tax administration for businesses and taxpayers across Australia.

The NSW Business Chamber believes there is merit in investigating this possibility in further detail, and that the Productivity Commission should be tasked with reviewing the feasibility and merits of such a proposal.

<sup>29</sup> Commonwealth Treasury, *2010-11 Budget*, Budget Paper No. 3, p. 67.

<sup>30</sup> Neil Warren, *Benchmarking Australia's Intergovernmental Fiscal Arrangements: Final Report*, NSW Government, 2006, pp. 89-90.

<sup>31</sup> See Neil Warren, *Intergovernmental fiscal arrangements as a constraint on State tax reform under Henry*, 2010, p. 6.

<sup>32</sup> NSW Office of State Revenue, *2008-09 Annual Report*, p. 19.

<sup>33</sup> State Revenue Office, *Annual Review 2009*, p. 9.

#### **Recommendation 4:**

**The Productivity Commission should investigate whether it would be more efficient for a single body to administer all State and Federal taxes.**

### Financial reforms in the Henry Review

The Henry National Review of Taxation presented a once-in-a-generation opportunity for substantial reform of Federal and State taxes and the transfer of revenues between jurisdictions.

In 2008, IPART noted that, “this Review provides a timely opportunity to achieve Commonwealth-State tax reform. Such opportunities occur infrequently, and it is important that the potential for coordinated Commonwealth-State reform and reform of the tax-transfer interface at the inter-governmental level is not lost.”<sup>34</sup>

The NSW Business Chamber has been a long time advocate for reform of State taxes. Given that State taxation raises less than one-fifth of national tax revenue and only two-fifths of total State revenue, it is difficult to justify the existence of 160 separate State taxes. These collectively entail high costs of administration for government (and therefore taxpayers) and heavy compliance burdens for business. The macroeconomic impact is a diminution of Australia’s potential competitiveness, productivity growth and prosperity.

The Henry Review agreed with this position, and found that “Many of the current State taxes are inherently of poor quality while other State taxes need to be reformed.”<sup>35</sup> The Review recommended the abolition of payroll taxes, insurance taxes and conveyance duties, and recommended reform of land tax, motor vehicle taxes, gambling taxes and resource royalties.<sup>36</sup> However, when it comes to outlining the process through which such reforms could be implemented, the Henry Review provided less guidance.

Comprehensive reform of inefficient state taxes will require reworking parts of the current Federal-State financial arrangements. Without such reform, the abolition of inefficient State taxes will increase State reliance on Federal grants and exacerbate existing vertical fiscal imbalance pressures. The Henry Review notes this risk, and acknowledges the importance of providing States with better revenue sources to replace the current suite of inefficient taxes.

Professor Neil Warren has recently completed an analysis of the degree to which current intergovernmental fiscal arrangements act as a constraint to the State tax reforms proposed under Henry.<sup>37</sup> It was found that, given the current arrangement of intergovernmental fiscal transfers, there is presently no incentive for the States to pursue any of the Henry reforms, given the detrimental impact this would have on State tax revenue.

The Federal Government could play a more active role in encouraging the States to undertake these reforms. Financial incentives provided by the Federal Government would encourage the States to progress these reforms, and the net result for the country as a whole would be a more efficient tax system and more effective financial relationships between Federal and State Governments.

Without leadership at the Federal Government level on this issue there will be little incentive for the States to act unilaterally to improve the efficiency of their respective tax bases.

#### **Recommendation 5:**

**The Federal Government should drive the COAG process towards a medium-term strategic plan for the implementation of the State tax reforms outlined in the Henry Review.**

### COAG and tax harmonisation

ACCI’s recent pre-election survey found that 91 per cent of NSW businesses hold major or moderate concerns about the complexity of the tax system. Part of this concern is driven by the inconsistencies in tax laws between the various States, and between the State and Federal Governments. While recognising the importance of individual States having the autonomy to set their own tax rates, it is difficult to justify different jurisdictions applying inconsistent definitions and tax rules. Greater harmonisation around the administration and application of tax laws

<sup>34</sup> IPART, *Review of State Taxation: Final Report to the Treasurer*, October 2008, p. 6.

<sup>35</sup> Commonwealth of Australia, *Australia’s Future Tax System – Final Report*, 2010, p680.

<sup>36</sup> Commonwealth of Australia, *Australia’s Future Tax System – Final Report*, 2010, p680.

<sup>37</sup> Warren, *Intergovernmental fiscal arrangements as a constraint on State tax reform under Henry*, June 2010.

would not encroach on State autonomy, while providing significant benefit to the business community, particularly to those businesses that operate in multiple States.

The NSW Business Chamber acknowledges that there has been some movement towards interstate harmonisation of taxes. For example, in 2007 NSW and Victoria worked together to implement broad harmonisation of payroll tax legislation, which commenced from 1 July 2007. Over the following years, Tasmania, Queensland, South Australia and the Northern Territory have also introduced harmonised legislation in this area. While the ACT and Western Australia have passed amendments to achieve harmonisation of many payroll tax elements, they have yet to introduce harmonised legislation.

This example highlights several important issues:

- The reform process was initially driven independently by two states, rather than centrally by the Federal Government or through the COAG process.
- Reform is slow and incremental. The payroll tax harmonisation process has now been running since early 2007, and while significant and valuable progress has been made, the States have yet to all fully sign up to the reform.

While NSW and Victoria have been able to drive progress in payroll tax harmonisation, the incentive for individual States to drive such processes is limited, as most of the benefits from improved harmonisation flow to businesses, not to the Government. In addition, individual States lack the authority and tools necessary to entice other States to join them in the reform process. Finally, the fact that improving harmonisation is a difficult and time consuming process can act as a disincentive and can discourage Governments from embarking on the reform process in the first place. To achieve comprehensive national harmonisation in a range of areas, the process needs to be driven at the national level.

In 2008, COAG took an active role in the harmonisation process through the *National Partnership Agreement to Deliver a Seamless National Economy*. This agreement has the continuing reduction of unnecessary and inconsistent regulation as one of its objectives. State implementation plans have set out 27 deregulation priorities under the agreement, all of which are to be implemented by the end of the 2012/13 financial year.

Progress against the agreement is monitored by the COAG Reform Council, which released its first progress report in February 2010. This report, which is expected to be publicly released later in August, assessed progress against the 2008/09 financial year milestones. While the progress report found that progress to at least a "satisfactory" level had been made in 18 areas, this would imply that progress against the remaining 9 priorities has been unsatisfactory. For example, the report found that reforms in the regulation of chemicals and plastics, and food, had all been "proceeding slowly."

Despite the lack of progress in some areas, it is encouraging that the Federal Government has been working to facilitate COAG progress. As interstate tax harmonisation is a national issue, it is appropriate that these reforms are driven by the national government. In addition, the Federal Government has the capacity to provide States with financial incentives necessary to encourage progress in this area.

Going forward, it will be important that the Federal Government continues to prioritise ongoing reform in this area and drives progress.

**Recommendation 6:**

**The Federal Government should continue to use COAG to expand and accelerate interstate tax and regulation harmonisation.**

## Improving the effectiveness of Local Government

The Sydney Metropolitan Area has 41 local government areas<sup>38</sup> with the metropolitan areas caught between a State Government too large to manage the multitude of decisions needed to help grow the city and local Governments trapped by NIMBYism and a lack of resources to make the right strategic decision.

The challenge for Sydney is to get the balance right. NSW Business Chamber believes the way to do this is by replacing Sydney's 41 Councils with ten strong regional councils. This idea was originally raised by the NSW Business Chamber in its policy blueprint, *10 Big Ideas to Grow NSW*.

The structure and activities of State Government agencies in Sydney would be aligned with the ten local government areas of the Sydney Metropolitan Area. These ten areas replicate the subregions of Sydney identified by the State Government's Metropolitan Strategy.

Strong regional councils with properly compensated and resourced elected representatives can improve decision making.

As a means of strengthening accountability within local government and to ensure no one area could dominate funding decisions within a region, there should be a ban on holding simultaneous offices within two levels of government. This would effectively mean banning councillors from holding office as a State MP. This is also appropriate given that funding of the regional councillors should represent full time salaries. As a matter of governance, this replicates the same ban that stops Federal Parliamentarians from holding simultaneous office in a State Parliament or Local Council.

The development of regional councils within the Metropolitan Area does not mean a loss of voice by local communities within the region. The development of a strong precinct system, that fed into broader decision making, could ensure that the views of local suburban communities were included in broader Council decision making.

Regional councils should also be able to achieve further economies of scale across areas of service delivery and the provision of back office services (ie IT services, rate collections, legal services to council etc).

A cut from the current 520 local government councillors to just 120 would shift the focus of councils away from the minutia of current decisions, to a more strategic approach to civic planning. Councillors should also be resourced to manage the increased responsibilities.

The ten proposed Regional Council Areas would be:

- City of Sydney (covering the current Local Government Area of City of Sydney);
- East Sydney (covering the current Local Government Areas of Botany Bay, Randwick, Waverley and Woollahra);
- South (covering the current Local Government Areas of Kogarah, Hurstville, Canterbury, Rockdale, Sutherland and Marrickville);
- Inner West (covering the current Local Government Areas of Ashfield, Burwood, Canada Bay, Leichhardt and Strathfield);
- Inner North (covering the current Local Government Areas of Lane Cove, North Sydney, Ryde, Willoughby, Hunters Hill and Mosman);
- North (covering the current Local Government Areas of Hornsby and Kur-ring-gai);
- North East (covering the current Local Government Areas of Manly, Pittwater and Warringah);
- West Central (covering the current Local Government Areas of Auburn, Bankstown, Fairfield, Holroyd and Parramatta);

<sup>38</sup> The Metropolitan Strategy lists 43 LGAs in the Sydney Metropolitan Area. However, NSW Business Chamber does not accept that Gosford and Wyong are LGAs are part of the greater Metropolitan Area. Rather they are part of the Central Coast region.



- North West (covering the current Local Government Areas of Baulkham Hills, Blacktown, Blue Mountains, Hawkesbury and Penrith);
- South West (covering the current Local Government Areas of Wollondilly, Camden, Campbelltown and Liverpool);

The NSW Business Chamber believes that the creation of these 10 super councils would significantly improve outcomes for NSW businesses and the community more generally. The proposed model would improve planning consistency and provide a closer alignment of State and Local Government responsibilities to link growth and development with infrastructure and the needs of local communities. Ten strong regional areas will also provide the right framework for other State Government agencies to align their activities along the same model providing greater levels of accountability across all portfolios of government.

In addition, it is expected that the move to larger local government areas will improve local government sustainability and administrative competency.

The creation of larger local government areas with stronger planning powers, represents a reversal of recent policy, which has seen the progressive emasculation of local council powers and funding within the Sydney Metropolitan Area.

We note that the Committee for Sydney has called for the Productivity Commission to “conduct a study into Australia’s capital cities to look at the economics and efficiencies of the creation of greater metropolitan areas similar to that which already exist in Brisbane.”<sup>39</sup> While the NSW Business Chamber has a slightly different vision for the future of local government in the Sydney area, we nonetheless see significant merit in having the Productivity Commission investigate the merit of local government amalgamations in more detail.

#### **Recommendation 7:**

**The Productivity Commission should investigate whether local government amalgamations in capital cities could improve the efficiency and effectiveness of this level of government.**

### Local Government rate pegging

Local governments raise revenue through rates, which in aggregate raise less than 5 per cent of total government revenue.<sup>40</sup> Local Governments are expected to provide a diverse range of services to their local community, and community expectations are increasing. Increasing demands are placed on local government whilst at the same time councils have had little access to appropriate levels of funding support. Local government operations throughout NSW suffer through a lack of certainty and flexibility.

Businesses recognise that it is critical that the operations of local government be made more sustainable. In 2009, a major study into the 100 largest local governments in NSW found:<sup>41</sup>

- 46 councils have sustainable financial and infrastructure policies;
- 16 councils are assessed as vulnerable;
- 37 councils have financially unsustainable policies.<sup>42</sup>

Rate pegging, which is a policy that caps rate increases to the CPI, has been in place in NSW since 1977 and is widely perceived to provide protection from excessive increases in rates. Councils, on the other hand, argue that it limits the capacity of councils to invest in longer term assets like infrastructure. The Northern Territory is the only other Australian State or Territory to have a system of rate pegging in place in the last decade.

Recently, IPART put forward proposals to the NSW Government which would provide options for NSW councils to seek additional rate rises over and above CPI provided conditions regarding council performance were met.<sup>43</sup> The proposed revised framework is designed to improve the rigour, transparency and independence of the rate pegging

<sup>39</sup> The Committee for Sydney, *Global Sydney: Challenges and Opportunities for a Competitive Global City*, October 2009, p. 4.

<sup>40</sup> University of Sydney, *Who’s Governing Sydney?* April 2007.

<sup>41</sup> Fiscal Star, *NSW Local Government Financial Sustainability Review, How sustainable are the existing financial and infrastructure policies of NSW Councils?* 2009

<sup>42</sup> Total number of councils equals 99, as one council had not published its statutory reports in full on its website.

<sup>43</sup> IPART, *Draft Report – Revenue Framework for Local Government*, July 2009.

process, while encouraging a longer term focus for revenue planning and rate setting. Councils would also be given greater flexibility in setting their rates where they had demonstrated sound financial management and a community mandate for their proposed medium term plans.

NSW Business Chamber supports the thrust of the IPART recommendations as a means of strengthening the capacity of local government to serve local communities.

**Recommendation 8:**

**The IPART recommendations regarding rate pegging should be adopted in NSW, with future revenue increases tied to performance improvement.**

Should you require further information or clarification of our submission, then please do not hesitate to contact Mr Micah Green, Policy Adviser – Business Environment and Economics on (02) 9458 7259 or via e-mail at [micah.green@nswbc.com.au](mailto:micah.green@nswbc.com.au).

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